MUNICIPAL BOND ISSUES EXPLAINED

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A great deal has been written and said relative to municipal bonds, but the majority of the investing public of to-day do not fully realize what a municipal bond is, and that when they have purchased the security of a municipality, they have an investment that is second to none.

In investing funds the first thing that should be considered by the prospective purchaser is what security is back of the loan. During the last few years a great many corporations have placed on the market bonds and stocks which if fully investigated would be found to have little certainty of absolute payment; yet the public purchases such stocks and bonds, not knowing why, but simply because they see these securities advancing daily. They expect to sell at a profit, thereby getting the return of their principal with satisfactory rate of interest at an early date, but they fail to realize that at least a great shrinkage in market value of this class of security must come sooner or later. This does not mean that there are no corporation bonds or stocks of merit on the market, for there are a great many issues on the market to-day that are sound beyond question. But when an investment is made in a municipal bond the buyer has a security, as hitherto stated, second to none, and one that can be converted into cash or which will be accepted as collateral for a loan at a moment's notice.

A great many municipal bonds have been issued in the past ten or fifteen years, and these have been purchased by the most conservative investors and national and savings banks of this country. This has had a tendency to increase the demand for this class of securities, inasmuch as the laws of a great many states practically compel the banks to invest their funds in nothing but municipal bonds, for the retrictions placed on other classes of securities are such as very few of the public corporations issuing bonds can comply with.

The naming of a municipal bond as the most desirable investment for banks and trust funds was caused through the realization,

by the courts of this country, that there is an absolutely sound foundation back of the loan should a calamity occur. All municipal bonds are issued in accordance with the laws of different states, pledging the full faith, credit, and all the real and personal property, of all the citizens of the municipality, thereby making the security an absolutely safe investment. If the investing public will always purchase a security with a tax duplicate to strengthen it, no fears need be entertained for the safety of their funds.

The Nature of a Municipal Bond

A municipal bond is a form of obligation in which a municipality acknowledges itself indebted, and agrees to pay the bearer at some future time (designated in the bond recital) its face value.

When any city, town, county or school district (the term "municipal" being used to designate any one of the four) has occasion to build water works, sewers, erect court houses, city halls, schools, or make other expenditures for the public good, involving an outlay beyond regular receipts, the law empowers the borrowing of funds, within certain limits, by issuing "promises to pay." These promises the "municipality" pledges itself to meet at some definite future time, with interest, payable usually every six months at some place which is designated as its fiscal agency; the written instrument being known as a municipal bond.

The chief elements of strength in municipal bonds lie in the right of the holder to compel payment and in the imperative duty of the municipality issuing them to meet both principal and interest by levying a tax upon all property within its limits. Such taxes become by law a prior lien to all other claims and must be met before satisfying any other obligations, whether contracted in advance of, or subsequent to, such tax levy. The above is borne out by the repeated decisions of the United States Supreme Court, recognizing the rights of the bondholder, which have resulted in placing municipal bonds next in security to United States Government bonds.

How the Value of Bonds Bought by Investment Bankers is Ascertained

One would naturally think that the only fact to ascertain is the market value of current investments. In this belief the investor who places his surplus funds through the services of a bond expert is

very much in error. Instead of merely figuring the return an investment brings in a specified time, when purchased according to the condition of the financial market, the value of a bond, to be determined accurately, must also be figured from many additional points of view.

The different items from which the value of a bond is derived, and the points always taken into consideration by the bond expert when he computes the bid to be submitted to the municipality offering the securities, must each be considered separately, before he is able to base a bid in accordance with the market. Should he not give every item due thought, the security could not be offered to his clientele and the general investing public, without some flaws being discovered.

Financial Conditions

Any change in the financial market for the worse must also be taken into consideration by the underwriter of an issue, for while municipal bonds do not at any time fluctuate much in value, a change in the financial conditions is apt to make the bond expert stand the loss of the profit counted upon, if it becomes necessary for him to "turn" his securities. Therefore the buyer must be very well informed at all times as to financial conditions, and must also know about where he will find a market for his purchase. The most important conditions to be taken into consideration when an offer for bonds is submitted to a municipality are the following factors:

For instance, if a certain city were to announce an issue of bonds for sale, the first matter the bond expert would consider would be the population taken numerically, the location of the town and character of its people. If the town is located in a good, productive territory, with ample railroad facilities, and shows a progressive spirit, the person intending to submit a bid, would feel that the security of such a municipality would be an absolutely safe one.

After careful study of the territorial situation, the financial condition of the city is to be considered. By this is meant the tax valuation, which comprises all the taxable real and personal property; any assets which the city may have in the way of water works, or electric light plants, and any accumulated sinking fund, that is, "money accumulated in various ways to pay off its indebtedness as

it matures." There is, also, the question whether or not the indebtedness of a municipality is excessive. This cannot be definitely decided, as the fact could be determined only after the various merits of that particular municipality had been taken into consideration. In some places a ten per cent debt would be regarded as excessive; in others, a twenty-five per cent indebtedness would still be considered safe.

Limit of Indebtedness

The bond expert also considers the limit of indebtedness allowed by various state constitutions on municipal investments legal for banks and corporations located therein. For instance, one state in the East places a restriction upon its savings banks, by limiting them to purchasing municipal securities located in certain states only; moreover the municipalities may not have a net indebtedness exceeding five per cent of the assessed valuation, and if it is an obligation of a city, the municipality must have a population of 10,000. Counties are required to have 20,000. By "net indebtedness" the "gross debt" is referred to, less any bonded indebtedness issued for the purpose of water works and the cash accumulated in the sinking fund. A municipality having a percentage of debt and a population which will allow its securities to be sold in markets having restrictions placed on them by the state constitutions will, of course, have a much wider market for its bonds than a municipality, the bond of which cannot be sold in a restricted market. This is a very important point in figuring the values of a security, for the security which is hampered with no conditions can be sold at a much better price.

Earning Rates

After the above facts have been carefully reviewed, the general condition of the country or prevailing earning rates of investments at the time, are to receive consideration. The bond expert, in making up his mind what will be a safe price to bid the municipality for its bonds, so that the bond firm can sell them to the investing public at a profit, will send a representative, trained in the bond business, and in many cases an attorney, to the municipality which intends to issue the security, to make a general inspection of the city, including all the subjects which have been discussed, and

especially the laws of the state under which the bonds offered are issued. If it is found that conditions are not such as the firm thought they were, the representative will discuss the matter with his firm and make a recommendation that they reduce the premium which they will offer for the securities. The men who are sent out to make these investigations are experts in their line, and it is seldom indeed that there is an error in their reports as to the value of a security.

Another feature which must be discussed in determining the value of a bond (when a bid is submitted by a bond house) is the life of an issue and the rate of interest it will bear; in fact, the ground from which the market value of a bond is really based (meaning the premium it will bear) is from the life and rate the security carries. If the bond has a long life, for instance, twenty or thirty years, and bears five per cent interest, the premium on that particular security would be considerable when placed before the public for investment purposes. A great many investors object to paying a high premium on bonds (and this, therefore, must be taken into consideration in figuring), as they cannot see the difference between a security commanding a high premium and one bearing a low premium. Many even say, "We see no reason why we should pay any premium as the municipality issuing the security should pay the bond broker a commission for negotiating the transaction." This would all be very well if there were only one bond house in the business, but when it is argued that there are upwards of a dozen competitors at each offering of bonds by municipalities, and all anxious to secure them, it can be readily seen that the competition for this class of securities is very keen, and that only one, or a previously formed syndicate, can be successful, and that one is the firm or syndicate offering the largest premium.

Method of Bidding

When the price which the firm feels it is safe to bid has been agreed upon, sealed bids for the issue are submitted to the proper officer of the municipality. These bids are opened at a stipulated time and the bonds are awarded to the firm offering the highest premium, in addition to the par value and the interest accrued to date of delivery of the bonds. This award is made if the conditions of the advertisement of sale have been complied with by

the bidder. Should the high bidder not have complied with the conditions in the advertisement, the bonds will generally go to the next higher bidder who bids in conformity with the advertisement.

Delivery

After the award has been made by the proper officials of the municipality, the clerk of the corporation submits to the successful bidder a complete set of transcripts leading up to the issuance of the bonds. These transcripts include every legal step taken by the officials in the issuing of the securities until the time of sale. The transcripts are submitted, by the firm purchasing the securities, to some eminent legal counsel making a specialty of examining into the legality of public securities, and having no interest in a financial way, either in the firm which submits the papers to them, or in the city itself. If the attorneys examining the validity of the bonds give their approving opinion, the bonds are taken up and paid for by the successful bidder. However, about twenty-five per cent of municipal issues which are placed on the market, are generally found to be legally irregular, and the purchaser is consequently unable to conclude the purchase. An eminent attorney's approving opinion on the legality of a block of bonds, adds to their value.

Broker's Commission

When the bonds have been properly issued and paid for by the purchaser, an offering is made by the holder to his clientele and the general public, as an investment for their surplus funds, at a price which will generally allow the bond expert about one per cent for his services. A great many securities, however, are handled at less than the above-named profit and many at more, the profit made depending greatly upon the grade of the security offered.

If the public knew the vast amount of work the bond expert does, the number of people employed to secure correct information and the various systems in use, in order that the investigations may be made properly, and that information may be at hand at all times on old as well as new issues, so that the firm may conduct the business successfully and offer to the investing public investments in which they can safely place surplus funds—no doubt those availing

themselves of the service of the bond firm would wonder how the business could be conducted on the small profit asked over purchase price. All this, however, is obtainable on account of the big demand for the class of securities discussed, which again proves "the high regard in which municipal securities are held, if the same are bought and put upon the market by a firm properly equipped."